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Before the
FEDERAL COMMUNICATIONS COMMISSION
Washington, D.C. 20554

In the Matter of	)	
	)	
Implementation of the Telecommunications Act of 1996:	)	CC Docket No. 96-150
	)	
Accounting Safeguards Under the Telecommunications Act of 1996	)	

NYNEX REPLY COMMENTS

The NYNEX Telephone Companies

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Dated: September 10, 1996

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SUMMARY

These Reply Comments of NYNEX in the Accounting Safeguards Proceeding show that the Commission should reject commentors' proposals that are: counter to the deregulatory, procompetitive intent of the Act to encourage BOC and LEC innovative offerings such as long distance competition to entrenched interexchange carriers; and are not necessary to satisfy the Act's accounting requirements and preclude cross-subsidy. Under its price cap regime, the Commission should continue a course towards less reliance on regulatory accounting rules, and certainly not adopt stricter accounting requirements as urged by some parties who would disadvantage their telephone company competitors.

In its NPRM in this docket, the Commission stated that (¶ 12): "those urging that we adopt more detailed accounting safeguards then those in our current rules or those specifically mandated by the 1996 Act bear a heavy burden of persuading us to adopt such safeguards." Despite this admonition, various parties propose detailed and burdensome accounting requirements that unjustifiably go beyond the Telecommunications Act of 1996 (the "Act"). Such proposals are contrary to the deregulatory intent of the Act.

Predictably, some commentors try to advance their private competitive interests by placing disparate regulatory handicaps upon BOCs and LECs who would try to compete with them. For example, incumbent interexchange carriers ("IXCs") would subject BOC interLATA services to a heavy blanket of regulation designed to drive up BOC prices for such services to give the incumbent IXCs the benefit of umbrella pricing. These proposals would thwart the introduction of effective BOC competition in the current price collusive interexchange market.

The Commission should firmly reject such proposals that are contrary to the pro-competitive intent of the Act and FCC policies.

In Section II, we show that commentors fail to demonstrate a significant link between interstate regulated costs and regulated rates under the Commission's price cap regime. Therefore, the Commission to the extent possible should forbear from applying, or waive Part 64 cost allocation and affiliate transaction rules. In the event the Commission retains those rules as a supplement to price cap regulation, they will more than adequately satisfy the Act's accounting safeguards in the context of integrated operations (Section III) as well as separated operations (Section IV). Finally, commenting parties provide no basis for expanded exogenous treatment of cost reallocations from regulated to nonregulated activities.

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NYNEX REPLY COMMENTS

I. INTRODUCTION

The NYNEX Telephone Companies[1] ("NYNEX") submit these Reply Comments to parties' comments filed August 26, 1996, in the above-captioned matter.

In its Notice of Proposed Rulemaking ("NPRM") released July 18, 1996, in this docket, the Commission stated that (¶ 12): "those urging that we adopt more detailed accounting safeguards then those in our current rules or those specifically mandated by the 1996 Act bear a heavy burden of persuading us to adopt such safeguards." Despite this admonition, various parties propose detailed and burdensome accounting requirements that unjustifiably go beyond the Telecommunications Act of 1996 (the "Act"). Such proposals are contrary to the deregulatory intent of the Act.

[1] New England Telephone and Telegraph Company and New York Telephone Company.

Predictably, some commentors try to advance their private competitive interests by placing disparate regulatory handicaps upon BOCs and LECs who would try to compete with them. For example, incumbent interexchange carriers ("IXCs") would subject BOC interLATA services to a heavy blanket of regulation designed to drive up BOC prices for such services to give the incumbent IXCs the benefit of umbrella pricing. These proposals would thwart the introduction of effective BOC competition in the current price collusive interexchange market. The Commission should firmly reject such proposals that are contrary to the pro-competitive intent of the Act and FCC policies.

II. PARTIES DO NOT JUSTIFY CONTINUED APPLICATION OF THE PART 64 RULES UNDER THE FCC's PRICE CAP REGIME

NYNEX has shown that under the FCC's price cap regime with no sharing/low-end adjustments, the link between interstate regulated costs and regulated rates has essentially been broken.[2] Accordingly, the FCC to the extent possible should forbear from applying, or waive Part 64 Rules. Some commenting parties (e.g., AT&T, MCI), in a misguided effort to keep unnecessary Part 64 Rules not only locked in place but augmented, try to conjure up links between regulated costs and regulated rates.[3] However, as NYNEX has demonstrated (pp. 6-8), the availability of exogenous cost adjustments, productivity factor adjustments and State regulation do not necessitate the FCC's continuation of Part 64 Rules.

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[2] NYNEX 4-9.

[3] MCI offers its familiar rhetoric (pp. 4-5) about BOC and LEC supposed "market dominance" in local exchange and exchange access markets and supposed incentive and ability to cross-subsidize, but fails to acknowledge the growing and intense competition with respect to various regulated telephone services, particularly in the NYNEX region. Notably, MCI is now offering MCI Local Service[SM] For Business in the New York area. See, e.g., MCI advertisement in The New York Times, September 4, 1996, p. D5.

MCI states (p. 5) that price cap LECs each year can choose a productivity factor option involving sharing. However, as long as carriers like NYNEX are under a no-sharing option, cost allocations between regulated and nonregulated activities simply do not affect interstate regulated rates. Further, the Commission intends to eliminate sharing entirely from the permanent price cap plan for LECs.[4]

MCI also contends (p. 39) that Part 64 is needed to monitor the price cap system.[5] This contention hardly justifies continuing Part 64 Rules where the FCC has made a firm policy choice in favor of price cap regulation over rate of return regulation. Given that choice, Sprint is clearly wrong in asserting (p. 18) that the Commission must monitor and evaluate LEC profit levels. Instead, the Commission should complete the task of eliminating all vestiges of rate of return regulation, including superfluous regulatory accounting rules.

The NY DPS also suggests (p. 11) that Part 64 is necessary to properly estimate Universal Service subsidies to fulfill Section 254 of the Act. However, alternatives such as calculating the Universal Service Fund based on a "proxy factors" system have the support of many carriers and regulators, [6] without the need to retain all the details of Part 64.[7]

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4 See LEC Price Cap Performance Review Order, CC Docket No. 94-1, 10 FCC Rcd 8961, ¶¶ 191-193 (1995); X-Factor NPRM, CC Docket No. 94-1, released September 27, 1995, ¶ 114.

5 See also NY DPS 11, Sprint 18.

6 See Comments of the following parties in the Universal Service Docket 96-45, filed April 12,1996: AT&T at Appendix p. 1, LDDS WorldCom at p. 10, MCI at p. 10, NYNEX at pp. 9-16, Sprint at p. 8, TCG at p. 7, U S WEST at p. 8, Florida PSC at pp. 9-10, Pennsylvania PUC at pp. 17-18, Wyoming PSC at p. 17.

7 Several parties maintain that Part 64 cost allocations are needed to implement pricing requirements under Sections 251 and 252 of the Act. See CompTel, LDDS WorldCom, NY DPS. This argument misses the mark. In its recent Order in the Interconnection proceeding, the Commission set forth pricing requirements for interconnection and network

Finally, if, notwithstanding the compelling record in this docket, the Commission continues to apply Part 64, NYNEX supports the streamlining of Part 64 as recommended by USTA (in its Attachment); and, as discussed infra, NYNEX opposes additional regulatory accounting requirements.

III. NO BASIS IS PROVIDED FOR PROMULGATING ADDITIONAL SAFEGUARDS FOR INTEGRATED OPERATIONS

A. BOC Integrated InterLATA Services

Even though the Act does not require BOC out-of-region interLATA telecommunications to be provided through a separate affiliate, MCI urges structural separation and references its comments filed in the Out-Of-Region proceeding, CC Docket No. 96-21. MCI also requests dominant carrier regulation of such services.[8] MCI's position is wrong and outside the scope of this proceeding. The Commission has already issued an Order in Docket 96-21[9] providing for non-dominant carrier regulation of BOC out-of-region interLATA telecommunications services, where the BOC elects to offer such services through a company meeting certain separation requirements less stringent than under Section 272 of the Act. BOCs appropriately have the option of providing those services on an integrated basis.

MCI goes on to assert that, if a BOC provides out-of-region or other interLATA services on an integrated basis, the Commission should not simply treat such services as nonregulated,[10] but should require service-specific subsidiary accounting records similar to prior regulated video

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elements that do not rely upon Part 64 allocations. See CC Docket No 96-98, First Report and Order released August 8, 1996, ¶¶ 694-699, and proposed FCC Rule 51.505.

8 MCI 12-13.

9 Released July 1, 1996.

10 Nonregulated treatment is urged by CompTel (p. ii) and TRA (p. iii).

dialtone requirements.[11] This position is without merit. The Commission's existing rules provide more than adequate safeguards against cross-subsidy.[12] Thus, in the case of regulated, integrated interLATA services (such as Corridor Service), the FCC's Part 36, Part 69 and price cap rules provide effective safeguards. The costs in the Part 69 Interexchange Basket cannot be shifted so as to increase the prices of services outside that basket. In the case of nonregulated, integrated interLATA services, the Commission's price cap regime and Part 64 Rules assure against improper cost shifting.

Section 272(e)(3) requires that "[a] Bell operating company ... impute to itself (if using the [exchange] access for its provision of its own services), an amount for access that is no less than the amount charged to any unaffiliated interexchange carriers for such service ...." To

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[11] MCI 13-14; see NPRM ¶ 39. MCI claims there is a great potential for cross-subsidization between local and interLATA service, and encourages the Commission to include the costs of interLATA services as regulated costs for the purposes of applying Part 64. But the video dialtone model was doomed to failure due to burdensome regulation, which is why Congress struck down the impractical, unworkable accounting requirements that were developed. See Section 302(b)(3) of the Act.

[12] NYNEX 14-15. LDDS WorldCom's comments are predicated on a basic misunderstanding of the Commission rules. First, LDDS WorldCom insists (pp. 12-13) that RBOCs must be required to apply the Part 32 Uniform System of Accounts ("USOA") to their integrated provision of out-of-region interLATA services and local exchange and access services. Local exchange carriers are subject to the USOA by definition. Thus, if interLATA services are integrated (i.e., provided within the regulated entity that provides local exchange services), then Part 32 is applied to all services provided by that entity. Second, LDDS WorldCom apparently does not understand that Part 64 cost allocation rules pertain to the allocation of an entity's total booked costs. The cost allocation rules were promulgated in lieu of a requirement to have a separate subsidiary or a separate set of books. Thus, contrary to LDDS WorldCom (p. 13), there are no "separate account[s] within the nonregulated category." Part 32 establishes the accounts that regulated LECs are required to maintain and the accounting rules for determining the amounts that are recorded in those accounts. Part 64 is then used after the books are closed to separate the costs on a company's books between regulated and nonregulated activities, based on direct assignment to the extent practicable and principles of cost causation.

implement this requirement, AT&T argues that BOCs should be required to record the imputed access charge as an expense to be assigned to nonregulated activities, with a credit to regulated revenues.[13] This argument has no basis. First, in the case of regulated, integrated interLATA services such as Corridor Service, the Commission as a pricing (not accounting) matter has already required access charges to be imputed.[14] Second, in the case of nonregulated, integrated interLATA services which utilize access, the Commission's rules properly provide for nonregulated revenues to be debited (to offset a credit to regulated revenues), so as to avoid an artificial inflation of total company revenues.[15] Given this treatment, there is no need for additional rules requiring expense accounting of imputed access charges.

AT&T further maintains that the Commission should establish price floors at a level at least equal to the imputed access charge plus the incremental cost of the non-access portions of the service.[16] This argument for additional regulation of pricing should be rejected since it is outside the scope of this matter and would impose disparate requirements on BOCs (see discussion infra under Safeguards For Separated Operations).

B. Payphone Services

APCC makes broadbrush recommendations that the Commission must strengthen its cost allocation and affiliate transaction rules for BOCs and incumbent LECs, in order to prevent

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13 AT&T 19.

14 See Application Of Access Charges To The Origination And Termination Of Interstate IntraLATA And Corridor Services, FCC 85-172, 57 R.R.2d 1558, ¶ 9 (1985).

15 See FCC Rule 32.5280; Separation Of Costs, CC Docket No. 86-111, Further Reconsideration Order, 3 FCC Rcd 6701, ¶ 15 & n. 15 (1988). This implements the FCC's requirement that "[t]ariffed services provided to a nonregulated activity will be charged to the nonregulated activity at the tariffed rates...." FCC Rule 64.901(b)(1).

16 AT&T 19; see also MCI 27.

subsidies and discrimination with respect to payphone services.[17] The RBOC Payphone Coalition (the "Coalition") is submitting its own Reply Comments that address the APCC's recommendations in detail. NYNEX supports the Coalition's Reply Comments, which demonstrate that the APCC's recommendations should be rejected for a number of reasons.

First, the APCC's arguments concerning discrimination are beyond the scope of this proceeding and are incorrect in any event -- Section 276 specifically allows for use of the nonstructural safeguards, including the non-discrimination requirements, adopted in Computer Inquiry III[18] in the provisioning of payphone service, and the APCC has failed to carry the heavy burden the Commission has stated it must bear in asserting that more stringent safeguards are necessary.[19] Second, the alleged differences between the history of enhanced services and the history of payphone services that the APCC relies upon in recommending (pp. 3-4) more stringent safeguards, provide no reason to adopt that recommendation. Indeed, any such differences -- including the fact that the FCC has promulgated price cap rules since it adopted the safeguards in the Computer Inquiry III proceeding involving enhanced services, and the fact that payphone services involve fewer joint and common costs than enhanced services -- argue in favor of less safeguards in the provisioning of payphone services, not more as APCC recommends. Third, contrary to APCC's assertion (pp. 4-5), the Act does not increase the likelihood of cross-subsidization since it permits the BOCs to participate in other lines of business while providing for a "judicious mix" of safeguards to protect against anti-competitive

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[17] See, e.g., APCC 7.

[18] See NPRM ¶ 28 & n. 38, ¶ 58.

[19] See NPRM ¶ 12.

conduct. Fourth, nothing in Section 276 or Computer Inquiry III (which is specifically referenced in that Section) provides that the BOC must make available to non-BOC payphone providers all the operational functions it makes available to the BOC payphone operations, and APCC's recommendation to that effect is nothing more than a tortured reading -- indeed a distortion -- of the Act.[20] Fifth, APCC's recommendation (pp. 8-10) that the affiliate transactions rules apply to the BOC payphone services even where they are provided on an integrated basis with regulated activities would make for an unreasonable and unwarranted extension of the Commission's affiliate transactions rules, for APCC's anti-competitive purposes.[21] Finally, APCC's recommendation (pp. 18-19) that the Commission impose a royalty fee on BOC payphone operations is contrary to ample FCC precedent rejecting just such a recommendation in similar contexts.

C. **Telemessaging**

MCI incorrectly states (pp. 11-12) that telemessaging services must be provided through a separate affiliate.[22] First, the Commission has tentatively concluded that only interLATA telemessaging services must be provided through a separate subsidiary.[23] Second, to the extent that a BOC currently provides intraLATA telemessaging service or was providing interLATA

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[20] See APCC 3, 6-8.

[21] Furthermore, the FCC's affiliate transaction accounting rules do not and should not dictate that carriers or their affiliates charge any particular prices for services provided or assets transferred. See NPRM ¶ 63.

[22] A similar contention is made by VoiceTel (p. 13).

[23] NPRM ¶ 33. In CC Docket No. 96-149, NYNEX addressed the definition of interLATA information services. Among other things, we showed that definition does not include a BOC information service where another entity provides interLATA transport. CC Docket No. 96-149, NYNEX Comments filed August 15, 1996, pp. 42-45; NYNEX Reply Comments filed August 30, 1996, pp. 27-28.

telemessaging service on the date of enactment of the Act (previously authorized activities), those services can continue to be provided on an integrated basis pursuant to Section 272(a)(2).[24]

To support its position that all BOC telemessaging must be subjected to structural separation, VoiceTel asserts (p. 5) that FCC Part 32/Part 64 cost accounting safeguards do not adequately preclude cross-subsidy. Here again, VoiceTel is wrong. The FCC and courts have consistently upheld the efficacy of those safeguards.[25] VoiceTel provides no basis not to adopt the Commission's tentative conclusion that "applying our Part 64 Rules to telemessaging will safeguard against the subsidies prohibited by Section 260(a)(1)."[26] These rules have been successfully applied to BOC telemessaging (including NYNEX Voice Messaging Service) for more than seven years.[27]

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24 Even if structural separation were required, MCI's proposal that BOCs remove common or shared costs from their Part 32 accounts is nonsense. Any such costs which are common or shared are so designated because they are also used in the provision of regulated telecommunications services. Costs incurred in the provision of regulated telecommunications services would not be "removed" from the Part 32 books. Moreover, only investment costs can be "removed" from a company's books of account and transferred to an affiliate. Expenses are current period costs properly recognized in the period incurred by the LEC entity. Accordingly, even if a separate affiliate were to be formed for telemessaging, expensed costs which are currently on the BOC's books are properly recorded and would not be "removed" from the BOC's Part 32 books and "transferred" to the separate affiliate.

25 See NYNEX 9-11. In California v. FCC, 39 F.3d 919 (9th Cir. 1994), the Court upheld the FCC's determination that its cost accounting rules together with price cap regulation adequately prevent cross-subsidy.

26 NPRM ¶ 33.

27 VoiceTel also questions (p. 12) the Commission's wherewithal to enforce its cross-subsidy safeguards. The Commission rejected this argument in the BOC Safeguards Order (¶ 54) and elsewhere. See BOCs' Joint Petition For Waiver Of Computer II Rules, DA 95-36, Order released January 11, 1995 (Com. Car. Bur.); Video Dialtone Reconsideration Order, 10 FCC Rcd 244, ¶¶ 179-182 (1994). The Commission now has nearly nine years of experience enforcing its cost accounting safeguards, and no basis is offered by VoiceTel or other parties to doubt the Commission's continued capacity to effectively regulate in this area.

For its part, ATSI unloads a series of proposals pertaining to unbundling, collocation and pricing[28] of competitive services. ATSI's hodgepodge of assertions is outside the scope of this accounting safeguards docket and should be discarded.

IV. SAFEGUARDS FOR SEPARATED OPERATIONS NEED NOT BE EXPANDED BEYOND CURRENT RULES

A. In-Region InterLATA Services

Incumbent IXCs propose to burden BOC in-region interLATA services with regulatory requirements which are beyond the mandate of the Act and would competitively disadvantage BOCs. Those incumbent IXCs' arguments are particularly meritless, and should be kept in proper perspective.

The additional structural and accounting safeguards they promote are not to protect the telephone ratepayer or promote competition, but to insure their market power in the long distance market and to extend their influence into the local exchange market. Mr. Paul W. MacAvoy, professor and the former dean of the Yale School of Management indicates that since 1990 the long distance market has functioned as an oligopoly.[29] He argues that AT&T has established rates for services that increase each year and MCI and Sprint have followed. These rate increases have occurred during a period when access prices have been declining.[30]

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28 The Commission has made clear that its Part 64 Rules do not dictate pricing of nonregulated activities. Separation Of Costs, Joint Cost Order, CC Docket No. 86-111, 2 FCC Rcd 1298, ¶ 40 (1987).

29 The New York Times, "AT&T Assails a Study by Economist," September 2, 1996.

30 CC Docket No. 79-252, Further Opposition of Bell Atlantic Corporation, BellSouth Corporation, Pacific Telesis Group, and SBC Communications Inc. to AT&T's Motion for Reclassification as a Nondominant Carrier (June 9, 1995).

Both AT&T (p. 3) and MCI (p. 27) assert that BOCs have the ability to act anti-competitively in the interexchange market and that merely requiring the BOC's separate affiliate to purchase access at tariffed rates does not provide sufficient protection. AT&T argues (p. 3) that a nonaffiliated IXC must absorb "inflated" access rates as a real cost, while a BOC and its affiliate do not, enabling the BOC and its affiliate to underprice competitors and harm the competitive process. MCI claims that the process allows the BOC and its affiliate to price their respective services to maximize total profit, whether or not that leads the affiliate to sell at a loss. Both argue that there is a requirement for a price floor for interLATA services that covers the BOC's access charges plus all other costs.[31] AT&T even goes on to suggest that the Access Reform proceeding should require all exchange access to be priced at long-run incremental cost to create "a more even playing field."

First, this proceeding is not the appropriate forum to present positions on access reform. The Commission has indicated that both access reform and universal service will be addressed in separate dockets.

Second, not surprisingly, AT&T and MCI propose regulated price floors, and additional monitoring procedures for the BOCs' long distance affiliates. As stated in NYNEX's Comments in CC Docket No. 96-149,[32] the burdensome conditions of dominant carrier regulation suggested by AT&T and MCI would serve only to impair the ability of the affiliate to compete effectively and efficiently as a new entrant. In those Comments we demonstrated (pp. 48-60) the appropriateness of classifying and regulating the BOC's affiliate as a non-dominant long distance

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[31] AT&T 11, MCI 27.

[32] Filed August 15, 1996, p. 57.

carrier. Our Comments pointed out that the Commission itself recognized in the Competitive Carrier proceeding that subjecting non-dominant carriers to pre-disclosure to competitors of their business plans through prior facility approvals, or by advance tariff and detailed cost requirements, would not serve the public interest.[33]

Additionally, in NYNEX's Comments in Docket 96-149, we described effective reporting requirements contained in the Act (see also infra). Section 272(b)(5) requires that all transactions between a BOC and its separate affiliate be reduced to writing and be made available for public inspection. Section 272(d) requires the BOC to conduct an external audit every two years to evaluate the company's compliance with the structural separations rules and with the accounting requirements. The results of the audit must be submitted to the State regulatory authorities and to the Commission, and be made available for public comment. Also, the Act requires BOCs to maintain records that will facilitate enforcement. Given these safeguards, AT&T's and MCI's speculation of anticompetitive activities, and their clamor for long distance price floors, are unfounded and unwarranted.

MCI further asserts (pp. 34-35) that each BOC interLATA affiliate must keep a Cost Allocation Manual presenting detailed accounting information. This recommendation should be rejected, since it is not required by the Act and does not apply to similarly situated incumbent IXCs. The Section 272 audit process, as well as the existing Section 208 complaint process and FCC cost accounting safeguards (including treating the separate interLATA affiliate as

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[33] CC Docket No. 96-149, NYNEX Comments, pp. 57-58; NYNEX Reply Comments filed August 30, 1996, p. 33. See AT&T 18 (urging that detailed financial information -- which would be highly competitively sensitive -- of the BOC separate affiliates be made public).

nonregulated for affiliate transactions rules purposes), are more than adequate to prevent and/or detect cross-subsidy or anticompetitive conduct.

Several incumbent IXCs also maintain that the BOC interLATA affiliate must follow the FCC's Part 32 Uniform System of Accounts.[34] NYNEX strongly opposes this recommendation. AT&T and MCI concede that the BOC separate affiliate for manufacturing and/or interLATA information services should only follow GAAP. NYNEX believes that, at most, GAAP should be required of the long distance affiliate, where that affiliate will be nondominant and a "nonregulated entity" for affiliate transactions purposes. In no event should BOC separate affiliates be required to adhere to accounting requirements not also applicable to similar situated incumbent IXCs or other entities.

B. Fair Market Valuation Of Inter-Affiliate Services; Prevailing Company Price

With respect to the possible adoption of identical valuation rules for inter-affiliate asset transfers and services, NYNEX has demonstrated (pp. 20-26) that: such approach would be exceedingly costly, burdensome, difficult to verify, highly subjective and against the public interest; and absent a tariff rate or prevailing company price, the Commission should continue to permit inter-affiliate services to be recorded at fully allocated cost as a practicable, verifiable and auditable method that offers a reasonable surrogate for fair market value. Concerning prevailing company price, we showed (pp. 26-28) that the FCC should retain and clarify its current rule whereby a non-tariffed asset or service is deemed to have a prevailing company price when the BOC or affiliate that furnishes the asset or service also furnishes substantial quantities of it to

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[34] AT&T 12, LDDS WorldCom iv, MCI 17. See also APCC 18 (supports separate affiliate's use of GAAP).

nonaffiliates. Where third parties are willing to pay such price in arm's length transactions with a willing seller, the price is a good indicator of value and is reasonable for recognition pursuant to FCC affiliate transaction rules. On these issues, NYNEX has essentially anticipated commentors' opposing arguments, and we will just mention several points here.

Some parties[35] support fair market valuation of services in order to carry out the arm's length provision in Section 272(b)(5). This argument is unconvincing. As the Commission recognizes, under its Computer Inquiry III regime, AT&T (and BOCs after divestiture, before structural relief) were required to provide CPE and enhanced services only through a fully separate subsidiary that would "deal with an affiliated manufacturing entity only on an 'arm's length' basis." The Commission also stated that "the transfer of any products" between this fully separate subsidiary and "any affiliated equipment manufacturer must be done at a price that is compensatory." The FCC further required that transfers between the fully separate subsidiary and another affiliate, of money, personnel, resources or other assets be "recorded in auditable form."[36] Under the FCC's Computer Inquiry III and related BOC CPE Safeguards[37] regimes which replaced Computer Inquiry II, the requirements of compensatory price and auditability have been carried out by Part 32/Part 64 nonstructural cost accounting safeguards. For transactions between the BOC telephone carrier and nonregulated affiliate, the BOC must record tariff price or prevailing company price (in that order, as applicable); and absent such prices, must record services at fully allocated cost and asset transfers at net book cost or fair market

[35] E.g., MCI 21.

[36] See NPRM ¶ 70 (emphasis added).

[37] Furnishing Of CPE By BOCs And ITCs, 2 FCC Rcd 143 (1987), recon., 3 FCC Rcd 22 (1987), aff'd, Illinois Bell Tel. Co. v. FCC, 883 F.2d 104 (D.C. Cir. 1989).

value, whichever is more beneficial to the telephone ratepayer.[38] Also under current rules, the BOCs must ensure an auditable paper trail is maintained with respect to affiliate transactions, as well as nonregulated activities.[39] Accordingly, the FCC's present rules sufficiently carry forth the compensatory pricing and auditability requirements of the "arm's length" standard, and no additional rules are warranted in this area.

Furthermore, BellSouth aptly points out that the fair market valuation of services proposal, which was rejected in the Joint Cost Reconsideration Order (¶ 131) but resurfaced in the Commission's 1993 Affiliate Transactions Notice,[40] "has not improved with age."[41] BellSouth indicates (n. 3) that the parties responding to that Notice overwhelmingly recognized and documented that the proposed rules would be extremely burdensome.[42] Moreover, developments since 1993 -- including greater competition and price cap regulation without sharing/low-end adjustments -- further militate against the adoption of such rules.

Regarding prevailing company price, it is noteworthy that even AT&T lends support to the continuation of the FCC's current rule, stating that: "the fact that such prices are determined in a market does provide some external discipline on the BOCs' and their affiliates' pricing methods."[43] Also, Sprint effectively refutes the Commission's assumption[44] that sales between

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38 See NYNEX 11-13.

39 See Joint Cost Order ¶¶ 242, 301; Joint Cost Reconsideration Order, 2 FCC Rcd 6283, ¶ 196 (1987); Automated Reporting (ARMIS) Requirements, CC Docket No. 86-182; FCC Rules 64.903, 64.904.

40 CC Docket No. 93-251, NPRM, 8 FCC Rcd 8076 (1993).

41 BellSouth v, 24-29.

42 See BellSouth n. 3.

43 See AT&T 14-15.

44 See NPRM ¶ 80.

affiliates generally do not require extensive marketing efforts and involve lower transactional costs than sales to nonaffiliates. Sprint points out (p. 12):

> In a competitive market with a variety of suppliers offering a plethora of price and service options, an entity has to work just as hard to sell to its affiliates as it does to non-affiliates. Otherwise, its affiliates will look to other suppliers.

Finally, APCC's proposal (p. ii) that services provided by a carrier to an affiliate be "priced at the higher of prevailing market prices, fair market value or fully distributed cost," is absurd and wrong. As discussed, the FCC's affiliate transactions rules dictate carrier regulatory accounting, not pricing. Also, since applying asset transfer rules to services is flawed, APCC's proposal is at least as flawed and duplicative since prevailing market price is equivalent to fair market value.

C. Other Issues In Connection With Separated Operations

-- Tariffed-Based Valuation:

MCI recommends that the Commission specify that the BOCs must record affiliate transactions at "generally available" tariffed rates, as opposed to Individual Case Basis ("ICB") tariffs that could "favor their own affiliates."[45] MCI's proposal serves no purpose. ICB tariffs are currently extremely limited in terms of the number of tariffs and their applicability. As MCI points out, the Commission in a September 1995 Public Notice discussed the limited nature of ICB offerings.[46] To the extent a BOC determines there is a need to introduce an ICB offering to

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[45] MCI 26.

[46] DA 95-2053, released September 27, 1995 (Com. Car. Bur.). The Public Notice observes that, since ICBs are not generally available to all customers, the Commission's policy requires that they should not be unreasonably discriminatory. The Commission has ruled that for an ICB to comply with its policy, the ICB must be for a service the carrier has not previously offered, the rates are an interim transitional measure, averaged rates are developed

meet the requirements of its long distance affiliate, the ICB tariff filed with the FCC would have to include support information subject to Section 61.38 of the Commission's Rules, and the BOC would have to complete a tariff review and approval process. The process allows for comments by interested parties, as well as a review by the Commission. The Access Reform proceeding will examine current regulations for access and determine what changes are warranted given the rapidly increasing levels of competition in the marketplace, and the need for greater pricing flexibility. Changes to current regulations will appropriately be addressed in the proceeding.

-- **Transactions Reduced To Writing And Available For Public Inspection:**

MCI addresses the Section 272(e)(1) requirement on BOC nondiscriminatory fulfillment of "requests" for tariffed services from itself, affiliates or nonaffiliates, and the Section 272(b)(5) requirement that affiliate "transactions" be reduced to writing and available for public inspection. In this regard, MCI argues (pp. 31-32) that "transactions" include "requests" for telephone exchange service and exchange access service. This argument is false. A common sense interpretation is that ordering and paying for service from the telephone company -- a process available to all customers on an evenhanded basis -- does not constitute a transaction within the meaning of the Act. The transaction is the actual provision of the service. Tariffed services are made available to the BOC itself, affiliates and nonaffiliates under the same rates, terms, and conditions. Moreover, under current FCC processes, the BOCs' ARMIS reports make public information on service installation intervals, which parties can use for comparison purposes to verify nondiscrimination.[47]

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within a reasonable time and the service is made generally available at these rates, and cost support information is provided.

[47] See NPRM ¶ 75.

Certain parties[48] also support additional requirements for BOCs to make public on the Internet and other mechanisms, detailed information relative to affiliate transactions. Such proposals are unnecessary and unwarranted. The FCC's current Part 64 CAM process adequately covers this area through BOC submission of detailed information on corporate affiliates; nature, terms, and frequency of affiliate transactions; nonregulated activities; incidental activities; time reporting procedures; financial impact of charges, etc.[49] The BOCs' CAM filings are made public for parties' scrutiny and participation in a pleading cycle.

-- **Rate Of Return Component Of Fully Allocated Costs**:

With regard to the return on investment component of fully allocated costs recorded for affiliate transactions, NYNEX supports the use of 11.25% (the current FCC-prescribed interstate rate of return), as well as the option of using a different rate of return so that a carrier could meet its obligations to both federal and State regulators and reduce its record-keeping burden. To similar effect, U S WEST indicates that BOCs should be permitted to continue to use a blended, or composite, rate of return based on the weighted average of the authorized interstate and intrastate rates of return for all jurisdictions within which the BOC operates.[50]

MCI contends that BOCs should be required to use 10.25%, on the basis such level falls within the FCC's zone of reasonableness. MCI also suggests that there is relatively lower business risk experienced by suppliers in affiliate transactions.[51] MCI's argument has no basis and should be rejected. There is one and only one FCC-prescribed rate of return -- 11.25%, not

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48 E.g., APCC, AT&T, MCI.

49 See FCC Rule 64.903.

50 U S WEST iv, 19-20.

51 MCI 28-29.

10.25%. A price cap LEC subject to sharing/low-end adjustments can seek a low-end adjustment if its interstate earnings fall below 10.25%. However, this does not mean 10.25% is a reasonable target rate of return. Moreover, many carriers, such as NYNEX, are currently not subject to sharing/low-end adjustments. Finally, the determination of business risk, cost of capital and rate of return for particular nonregulated affiliates or lines of business would be extremely complicated, and is certainly beyond the scope of this matter.

-- **<u>Section 272 Audit</u>:**

Section 272(d)(1) sets forth a straightforward requirement for a biennial audit:

> A company required to operate a separate affiliate under this section shall obtain and pay for a joint Federal/State audit every two years conducted by an independent auditor to determine whether such company has complied with this section and the regulations promulgated under this section, and particularly whether such company has complied with the separate accounting requirements under subsection (b).

NARUC recommends that the FCC require various detailed audit guidelines put forth by NARUC to be applied to the Section 272 audit process.[52]

NYNEX intends to continue to be reasonable, responsive and cooperative in dealings with our State Commissions and FCC. To the extent the NARUC proposal goes beyond the requirements of the Act, it should not be considered for adoption in this proceeding.[53] The audit process under Section 272 is self-executing, and should not be a matter for the adoption of

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52 NARUC 5-6, Appendix B, Appendix C.

53 For example, NARUC suggests that the first audit be performed for the first full fiscal year of the Section 272 affiliate's operations. NARUC, Appendix C, p. 15. Other parties suggest more accelerated time frames. <u>See</u>, <u>e.g.</u>, MCI 36-37 (alleging "it would be unwise to wait two years to conduct the first audit ..."); AT&T 17 (recommending annual Section 272 audit). These proposals should not be adopted. The Act clearly calls for an audit every two years, and no more frequent auditing is warranted.

additional rules. In each Section 272 audit, procedures and details can be worked out among the parties involved.

NYNEX recognizes NARUC's desire to clarify the Section 272 joint Federal/State audit requirements. As above, NYNEX also believes that incorporating the proposed audit guidelines into the FCC rules would be inappropriate. As an Order has not been issued by the FCC in this Accounting Safeguards proceeding, it is premature to issue audit guidelines. Subsequent to the issuance of an Order by the FCC, any guidelines should be addressed by all concerned parties. Additionally, NYNEX believes that any audit guidelines need to address the specific entity under audit. Given the rapid changes in the industry, the goals and procedures of a Section 272 audit need to be specifically tailored to each carrier. NYNEX also believes that each carrier subject to audit should have the opportunity to participate in the formulation of the Section 272 audit to ensure its fairness. Each carrier will be unique in its Section 272 affiliates, and the audit guidelines must reflect that uniqueness.

V. COMMENTORS PROVIDE NO BASIS FOR EXPANDING THE TYPES OF COST REALLOCATIONS FROM REGULATED TO NONREGULATED ACTIVITIES SUBJECT TO EXOGENOUS TREATMENT UNDER PRICE CAP RULES

Certain parties propose that any cost reallocations from regulated to nonregulated activities that arise from changes in the Part 64 process should be given exogenous treatment under LEC price cap regulation, so as to drive down price cap indices and interstate access rates.[54] As we demonstrated in initial Comments (pp. 31-34), such expansion of exogenous treatment is entirely unwarranted, since: it would likely create a double-count under the price cap formula; be inconsistent with FCC standards denying exogenous treatment for accounting

[54] E.g., GSA 8, MCI 38-39, Sprint 15-16.

rule changes not impacting discounted cash flow; and severely thwart LECs' incentive to engage in integrated nonregulated activities that would otherwise benefit the telephone ratepayers.

Parties supporting such expanded exogenous treatment provide no justification to overcome these points. They wrongly characterize the Commission's existing Rule 61.45(d)(1)(v) as requiring exogenous treatment for all reallocations of costs from regulated to nonregulated activities.[55] FCC Rule 61.45(d)(1)(v), as explained in the LEC Price Cap Order,[56] is narrow in scope. That rule only applies to the situation where, pursuant to Rule 64.901(b)(4), joint network plant is allocated using the forward-looking peak nonregulated usage allocator; actual reported nonregulated usage (Form 495B) turns out to exceed the projected forward-looking peak usage (Form 495A); and the carrier makes the required reallocation of network investment from regulated to nonregulated activities.[57]

Finally, it is important to emphasize that under the price cap rules, exogenous cost treatment in this context relates only to when regulated costs are removed and "reallocated" to nonregulated activities based on the forward-looking usage allocator process referenced above. The exogenous cost provisions do not, and cannot apply to the deployment of new network investment to provide both regulated and nonregulated services, where nonregulated costs were

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[55] See, e.g., GSA 8 n. 18, Sprint 15.

[56] CC Docket No. 87-313, 5 FCC Rcd 6786, ¶¶ 171-72 (1990). There the Commission indicated that the required exogenous cost adjustment relates to "required reallocations" pursuant to the Rule 64.901 provision whereby "carriers ... allocate common plant investment between regulated and nonregulated activities in accordance with a three-year forecast of relative regulated and nonregulated use."

[57] Companies have amended their Part 64 CAMs for new nonregulated services and cost pool changes on a regular basis. No such cost allocations have required exogenous adjustment. Long run productivity will increase where a company provides new services over an integrated network, realizing efficiencies in both the regulated and nonregulated areas.